Internal Revenue Service

memorandum

date: FEB 2 1989

to: District Counsel, Houston

from: John T. Lyons
Assistant Chief Counsel (International)
Kim A. Palmerino
Special Counsel (International)

subject: §956, Inquiry from Houston Examination, Group 1406

This responds to Examination's memorandum of January 20, 1988, in which it was requested we provide legal authority to support the proposed adjustment of $[redacted] under §956 for [redacted]. The issue is also present in subsequent years.

The §956 issue may be summarized as follows: A member of a U.S. consolidated group has a $[redacted] note payable to a CFC. Through a series of related party borrowings the U.S. company pays off the note within four months. The related party borrowings result in a different member of the U.S. consolidated group having a note payable to another CFC in the amount of $[redacted]. For [redacted]-[redacted] the facts are similar. CFC receivables are paid down to zero and within a week to ten days greater amounts are subsequently reloaned through other CFCs to other affiliated group members.

Question

May the IRS take the position that the $[redacted] note was not collected within one year and is, therefore, U.S. property?

We believe it is appropriate to challenge this scheme under §956 because the net effect of these transactions is to allow the U.S. affiliated group to have continual use of the earnings of its controlled foreign corporations in contravention of the express legislative intent behind §956. This conclusion is contingent upon factual verification of the information submitted to us by Examination, a copy of which is attached for your convenience. It appears Examination's conclusions are supported from information taken from the taxpayer's books.

Unfortunately, as discussed below, statutory authority is limited to §956. Legal authority for this proposition is most supportable under a "substance over form" approach.

(b)(5)(AC)
[redacted]

(b)(5)(AC) [redacted]

Discussion

Sections 951(a)(1)(B(and 956 were enacted as part of Subpart F by the Revenue Act of 1962 (Pub. L. 87-834) in response to perceived abuses by U.S. taxpayers through the use of controlled foreign corporations. The House Report, which adopted §956, stated that an objective of that section was "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 1447, 87th Cong., 2d Sess., (1962), at 58, 1962-3 C.B. 405, 462.

"Substance, and not form must be relied upon in determining the taxable significance of a transaction." Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). The above quote is taken from another case involving a §956 issue. In determining whether §956 applied, the Fifth Circuit in Greenfield et al v. Commissioner 506 F. 2d. 755 (5th Circ. 1975) affg. 60 T.C. 425 (1973), rejected the form of a transaction and instead looked to the substance, citing Court Holding. More recently, in Houchins v. Commissioner 79 T.C. 589 (1982), the court in discussing economic substance stated that "labels, semantic technicalities and formal written documents do not necessarily control the tax consequences of a given transaction. Rather we are concerned with the economic realities and not the form employed by the parties."

The facts which support the §956 adjustment are as follows. Corporation A is the domestic parent of a consolidated group which includes Corporations B and C, first tier domestic subsidiaries. Corporation D is a [redacted] financing company wholly owned by Corporation C. Corporations E, F and G are [redacted] companies. It is unclear whether Corporations E, F and G are owned by Corporation D, Corporation B or Corporation C. In any event it is clear that Corporations E, F and G are controlled foreign corporations.

From [redacted], through [redacted], Corporation E had made loans to Corporation B. As of [redacted], Corporation E's books reflected a note receivable from Corporation B in the amount of $[redacted].

On [redacted], a series of circuitous loans resulted in Corporation B's balance due to Corporation E being liquidated. First, Corporation E loaned Corporation F $[redacted]. On the same day Corporation F loaned Corporation D $[redacted]. Also, on [redacted], Corporation D purchased Corporation B's note for [redacted] from Corporation E. The substance of this

arrangement was the use of Corporation B's funds to substitute Corporation D for Corporation E as the creditor of Corporation B.

On [redacted], Corporation B borrowed $[redacted] from an unrelated U.S. commercial bank with the understanding that if the loan was repaid during the same banking day, no interest would be charged. The commercial bank transferred the $[redacted] to Corporation D's account, in payment of Corporation B's note held by Corporation D. Also on [redacted], Corporation D loaned Corporation C $[redacted]. The same day Corporation C loaned $[redacted] to Corporation A and approximately $[redacted] to other domestic affiliates. Corporation A, in turn, loaned $[redacted] to Corporation B which was used to liquidate the $[redacted] loan from the commercial bank.

During the period between [redacted], Corporation D called approximately $[redacted] of notes due from Corporation C and reloaned most of the funds to the domestic operating companies.

As of [redacted], earnings and profits of Corporations D, E and F were as follows:

Corporation D - $[redacted]
Corporation E [redacted]
Corporation F [redacted]

Based on the above, we believe it is appropriate to apply substance over form, to treat Corporation E as holding the obligation of a U.S. person in the amount of $[redacted] for the taxable year ending [redacted]. The whole series of transactions is nothing more than a disguised continuous repatriation of the earnings of the controlled foreign corporations. To the extent notes outstanding to the CFCs from the domestic affiliates exceed $[redacted] as of [redacted], such excess should be treated as an increase of investment in U.S. property.

Attachment

cc: Dave Jordan, Regional Counsel (Southwest)
Val Albright, ISTA Dallas